

## DEPARTMENT OF STATE REVENUE

01-20160166.LOF  
02-20160167.LOF**Letter of Findings Number: 02-20160167; 01-20160166  
Adjusted Gross Income Tax  
For Tax Years 2012 and 2013**

**NOTICE:** IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

**HOLDING**

Qualified research expense tax credits were properly disallowed for wages paid to various employees because Corporation and Shareholder failed to provide proper documentation to substantiate the time those employees spent on actually conducting, directly supervising, or directly supporting qualified research activities.

**ISSUE****I. Income Tax—Indiana Qualified Research Expense Tax Credits.**

**Authority:** IC § 6-8.1-5-1; I.R.C. § 41; Treas. Reg. § 1.41-2; IC § 6-3-2-1; IC § 6-3-1-3.5; IC § 6-3.1-4-1; IC § 6-3.1-4-4; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2012); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Indiana Dep't of State Rev. v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); IDOPCP, Inc. v. Comm'r, 503 U.S. 79 (1992); Stinson Estate v. United States, 214 F.3d 846 (7th Cir. 2000); Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96 (Ind. Ct. App. 1974); United States v. McFerrin, 570 F.3d 672 (5th Cir. 2009); General Motors Corp. v. Indiana Dep't of State Revenue, 578 N.E.2d 399 (Ind. Tax Ct. 1991).

Taxpayer protests the disallowance of claimed Indiana qualified research expense credits.

**STATEMENT OF FACTS**

Corporation is an S corporation that is a holding company for several affiliated entities, many of which are located in Indiana. Shareholder is an Indiana resident who has fifty percent ownership interest in Corporation. Corporation and Shareholder will hereinafter be referred to as "Taxpayer."

Corporation filed 2012 and 2013 Indiana corporate income tax returns, claiming Indiana qualified research expense tax credits on wages it paid to various employees to reduce its corporate income. As fifty percent owner, Corporation's income flowed to Shareholder, who was required to file his federal and Indiana individual income tax returns, reporting and remitting the income tax on the income received from Corporation.

The Indiana Department of Revenue ("Department") conducted an income tax audit of Taxpayer for tax years 2012 and 2013. In the audit, the Department reviewed several projects which Taxpayer reported as qualified research projects for the Indiana research expense tax credit ("Research Credit") claimed in both tax years. The Department agreed that all of the listed projects included in the Research Credit met the requirements to be qualified research expense projects. However, the audit adjusted reported qualified research expenses ("QREs") because the information pertaining to certain executive and managerial employees did not support that the individuals met the necessary criteria to have their wages included as qualified research expenses. This adjustment increased Shareholder's income tax liability, resulting in proposed assessments for both years.

Taxpayer timely protested the Department's reduction of the Research Credit. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protests. This Letter of Findings addresses Taxpayer's protests. Additional facts will be provided as necessary.

**I. Income Tax— Indiana Qualified Research Expense Tax Credits.**

## DISCUSSION

Pursuant to the audit, the Department disallowed the amount of QREs claimed on wages paid to various employees. The audit determined that information provided for certain executive and managerial employees ("Employees at Issue") did not prove that the individuals met the necessary criteria to have their wages included in the credit.

Taxpayer maintains that the Employees at Issue "either engag[ed] in qualified research, directly supervis[ed] qualified research, or directly support[ed] qualified research for each [qualified] project."

### A. Audit Results.

In the course of the audit, the auditor "requested all of the documentation for the audit years related to the research expense tax credit claimed on the returns." Included in this documentation were "details of labor hours per employee, supplies for the projects and the detailed explanations of each project." The auditor determined that "all of the listed projects included in the tax credit . . . meet the requirements to be classified as qualified research expense credits."

Despite its findings regarding the projects, the audit adjusted the amount of QREs used to calculate the Research Credit. The audit found that the Employees at Issue did not fit the requirements of direct line supervisors as the individuals did not "qualify as either persons conducting the actual research, or as persons directly supervising the persons conducting the research." These individuals were senior management with titles such as Plant Manager, Product Development, and Manager. Taxpayer provided job descriptions and an organization chart for the Employees at Issue. It was noted that, as it related to research, the Employees at Issue "attend[ed] meetings, [are] present during test runs in the plant, and meet[] with customers." The audit concluded that the information mentioned above was not verifiable for the purposes of claiming the QREs.

### B. Taxpayer's Response.

Taxpayer disagrees. In the protest letter, Taxpayer described the relevant activities and responsibilities each Employee at Issue performed for QRE purposes. Taxpayer claims that "each employee is either engaging in qualified research, directly supervising qualified research, or directly supporting qualified research for each [research and development] project." Taxpayer further explains that "Each employee has other responsibilities that are not qualified services . . . [and] most employees have less than 50 [fifty] percent of their time associated with [research and development] activities."

In support of its protest, Taxpayer provided a breakdown of employee hours per qualified project for each Employee at Issue. Each breakdown shows the employee's total base hours and wages, the percentage allocated to research and development projects and the total hours per project.

### C. Hearing Analysis.

As a threshold issue, it is the taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." *Indiana Dep't of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dep't of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); see also *Wendt LLP v. Indiana Dep't of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012). When an agency is charged with enforcing a statute, the jurisprudence defers to the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Indiana Dep't of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 583 (Ind. 2014).

In this protest, Taxpayer seeks to demonstrate that it is entitled to claim certain QREs. IC § 6-3.1-4-1 provides that "'Research expense tax credit' means a credit provided under this chapter against any tax otherwise due and payable under [IC 6-3](#)." Similar to deductions, exemptions, and exclusions, tax credits - such as research expense credits - "are matters of legislative grace." *IDOPCP, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992); *Stinson Estate v. United States*, 214 F.3d 846, 848 (7th Cir. 2000). The taxpayer who claims a tax credit against any tax is required

to retain records necessary to substantiate a claimed credit. Where such a credit is claimed, "the party claiming the same must show a case, by sufficient evidence, which is clearly within the exact letter of the law." Indiana Dep't of State Revenue, Sales Tax Division v. RCA Corp., 310 N.E.2d 96, 100-01 (Ind. Ct. App. 1974). The court in United States v. McFerrin summarized that "[t]ax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." 570 F.3d 672, 675 (5th Cir. 2009).

Nevertheless, the Department is well aware of the countervailing rules that a "statute must not be construed so narrowly that it does not give effect to legislative intent because the intent of the legislature embodied in a statute constitutes the law." General Motors Corp. v. Indiana Dept. of State Revenue, 578 N.E.2d 399, 404 (Ind. Tax Ct. 1991). Thus, in determining whether Taxpayer is entitled to claim the credits as originally submitted, it is Taxpayer's responsibility to maintain records fully justifying the credit.

For income tax purposes, Indiana follows the federal tax scheme with certain modifications. IC § 6-3-2-1(b); IC § 6-3-1-3.5(b). Indiana also provides certain tax credits which a taxpayer may claim to reduce its taxable income. See generally, [IC 6-3.1](#) and [IC 6-3.5](#). One of the tax credits is the "Indiana qualified research expense tax credit" under IC § 6-3.1-4-1, which, in relevant part, states:

As used in this chapter: "Indiana qualified research expense" means qualified research expense that is incurred for research conducted in Indiana.

"Qualified research expense" means qualified research expense **(as defined in Section 41(b) of the Internal Revenue Code as in effect on January 1, 2001).**  
**(Emphasis added).**

IC § 6-3.1-4-4 provides:

The provisions **of Section 41 of the Internal Revenue Code as in effect on January 1, 2001, and the regulations promulgated in respect to those provisions and in effect on January 1, 2001, are applicable to the interpretation and administration** by the department of the credit provided by this chapter, including the allocation and pass through of the credit to various taxpayers and the transitional rules for determination of the base period.  
**(Emphasis added).**

"Qualified research" is defined in I.R.C. § 41(d), as follows:

- (1) In general.--The term "qualified research" means research--
  - (A) with respect to which expenditures may be treated as expenses under section 174,
  - (B) which is undertaken for the purpose of discovering information--
    - (i) which is technological in nature, and
    - (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and
  - (C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose described in paragraph (3). Such term does not include any activity described in paragraph (4).
- (2) Tests to be applied separately to each business component.--For purposes of this subsection--
  - (A) In general.--Paragraph (1) shall be applied separately with respect to each business component of the taxpayer.
  - (B) Business component defined.--The term "business component" means any product, process, computer software, technique, formula, or invention which is to be--
    - (i) held for sale, lease, or license, or
    - (ii) used by the taxpayer in a trade or business of the taxpayer.
  - (C) Special rule for production processes.--Any plant process, machinery, or technique for commercial production of a business component shall be treated as a separate business component (and not as part of the business component being produced).
- (3) Purposes for which research may qualify for credit.--For purposes of paragraph (1)(C)--
  - (A) In general.--Research shall be treated as conducted for a purpose described in this paragraph if it relates to--
    - (i) a new or improved function,
    - (ii) performance, or
    - (iii) reliability or quality.
  - (B) Certain purposes not qualified.--Research shall in no event be treated as conducted for a purpose described in this paragraph if it relates to style, taste, cosmetic, or seasonal design factors.

The audit determined that the projects included in Taxpayer's 2012 and 2013 Research Credit met the requirements to be classified as qualified research projects under I.R.C. § 41 and that the project activities occurred in Indiana. However, to claim the Research Credit, Taxpayer must also demonstrate that the expenses incurred were qualified expenses for QRE purposes pursuant to I.R.C. § 41(b), which in relevant part provides that:

**Qualified research expenses.**--For purposes of this section--

(1) Qualified research expenses.--The term "qualified research expenses" **means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer--**

- (A) **in-house research expenses**, and
- (B) contract research expenses.

(2) **In-house research expenses.**--

(A) In general.--The term "in-house research expenses" means--

- (i) **any wages paid or incurred to an employee for qualified services performed by such employee**,
- (ii) any amount paid or incurred for supplies used in the conduct of qualified research, and
- (iii) under regulations prescribed by the Secretary, any amount paid or incurred to another person for the right to use computers in the conduct of qualified research.

Clause (iii) shall not apply to any amount to the extent that the taxpayer (or any person with whom the taxpayer must aggregate expenditures under subsection (f)(1)) receives or accrues any amount from any other person for the right to use substantially identical personal property. (**Emphasis added**).

Treas. Reg. § 1.41-2(c) further clarifies what qualified services are:

**Qualified Services**

(1) **Engaging in qualified research.** The term "engaging in qualified research" as used in section 41(b)(2)(B) means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

(2) **Direct supervision.** The term "direct supervision" as used in section 41(b)(2)(B) means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). "Direct supervision" does not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

(3) **Direct support.** The term "direct support" as used in section 41(b)(2)(B) means services in the direct support of either-

- (i) Persons engaging in actual conduct of qualified research, or
  - (ii) Persons who are directly supervising persons engaging in the actual conduct of qualified research.
- For example, direct support of research includes the services of a secretary for typing reports describing laboratory results derived from qualified research, of a laboratory worker for cleaning equipment used in qualified research, of a clerk for compiling research data, and of a machinist for machining a part of an experimental model used in qualified research. Direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities. For example, services of payroll personnel in preparing salary checks of laboratory scientists, of an accountant for accounting for research expenses, of a janitor for general cleaning of a research laboratory, or of officers engaged in supervising financial or personnel matters do not qualify as direct support of research. This is true whether general administrative personnel are part of the research department or in a separate department. Direct support does not include supervision. Supervisory services constitute "qualified services" only to the extent provided in paragraph (c)(2) of this section. (**Emphasis added**).

The regulation goes on to explain how to calculate the percentage used for employees who engage in both qualified and non-qualified research activities.

Wages paid to or incurred for an employee constitute in-house research expenses **only to the extent the wages were paid or incurred for qualified services performed by the employee**. If an employee has performed both qualified services and nonqualified services, only the amount of wages allocated to the performance of qualified services constitutes an in-house research expense. In the absence of another method of allocation that the taxpayer can demonstrate to be more appropriate, the amount of in-house research expense shall be determined by multiplying the total amount of wages paid to or incurred for the

employee during the taxable year by the ratio of the total time **actually spent** by the employee in the performance of qualified services for the taxpayer to the total time spent by the employee in the performance of all services for the taxpayer during the taxable year.

Treas. Reg. § 1.41-2(d)(1). (**Emphasis added**).

Taxpayer has already proven its listed projects qualify to be classified as qualified research expense projects. If Taxpayer wishes to include certain wages paid to or incurred for an employee in the Research Credit calculation, Taxpayer must show that the wages constitute in-house research expenses; i.e., the wages were earned when the employee was performing qualified activities. Thus, the issue in this case is whether the wages of the Employees at Issue can be considered QREs in the calculation of the Research Credit claimed.

The Department requested and reviewed "all of the documentation for the audit years related to the research expense tax credit claimed on the returns . . . Information provided included the details of labor hours per employee. . . ." Based on this review, the audit determined that the Employees at Issue did not "qualify as either persons conducting the actual research, or as persons directly supervising the persons conducting the actual research." Taxpayer provided job descriptions for the individuals, but the Department determined that that information "did not provide enough detail documentation to verify that these individuals met the necessary criteria to have their wages included as qualified research expenses."

In its request for hearing, Taxpayer again provided job descriptions for the Employees at Issue as well as documentation showing how each individual's time was allocated to qualifying projects. At the hearing, Taxpayer was asked to provide the job descriptions in affidavit form. Taxpayer's response was that this information had already been provided and "[T]axpayer does not believe it is necessary to provide an affidavit of the exact same job descriptions that have been provided during the audit and protest hearing letter."

Taxpayer was also asked to provide log sheets and explanations as to how employee hours were allocated to qualified projects. Specifically, the Department asked for log sheets of hours spent on a given project that could be tallied and tied to the total hours reported. Taxpayer was unable to provide such documentation. According to Taxpayer:

Each of the denied employees are salaried employees. These employees do not have logs that are submitted as they work on research and development projects. A study had previously been completed on the job responsibilities and job duties held by [employees]. It was determined during the study, their R&E activities, which included time spent in the areas of concept development, prototype development, process development and process validation represented a percentage of their overall time. This percentage was then used to allocate hours to research and experiment versus other non-research and experiment hours and across research and development projects.

Thus, the Employees at Issue wages which were allocated to qualified projects are estimates that cannot be substantiated with actual records. Further, Taxpayer did not provide a copy of the study referenced above. In the absence of such documentation, the Department cannot agree to the amount, if any, of hours/wages properly allocated to qualified projects.

It was also noted at the hearing that certain of the Employees at Issue supervised other employees with the title of "supervisor" or "manager." The Department requested explanations of those employee's jobs to determine which employee was directly supervising qualified projects. In response, Taxpayer generally explained that due to Taxpayer's small size, the denied plant managers have several responsibilities and tend to be more hands on in research and development activities. Plant managers are also present during "plant production scale Research and Development trials," which provide "proof of concept." As to those Employees at Issue who were indicated as involved with product development, Taxpayer noted that the employees "create product formulations, product prototypes, [and] evaluat[e] opportunities presented by the sales team. . . ."

Taxpayer had ample opportunity and time to provide the Department with documentation to substantiate the hours/wages claimed as part of the research expense credit. Taxpayer was unable to provide such documentation as the hours/wages allocated are estimations based on a prior study. Taxpayer did not provide this study. Further, Taxpayer was asked to provide affidavits of Employees at Issue job descriptions to support the QREs, but it declined to do so. Other information provided at hearing, while informative, was not sufficient to substantiate the QRE claimed. Thus, the Department is not able to agree that Taxpayer met its burden of proof as required by IC § 6-8.1-5-1(c).

**FINDINGS**

Taxpayer's protest is denied.

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